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Grassley and Levin introduce hedge fund transparency bill

WASHINGTON – Senators Chuck Grassley and Carl Levin introduced legislation today to close a loophole in securities law that allows hedge funds to operate under a cloak of secrecy.

The Hedge Fund Transparency Act of 2009 would clarify current law to remove any doubt that the Securities and Exchange Commission has the authority to require hedge funds to register, so the government knows who they are and what they're doing. It would close the loophole previously used by hedge funds to escape the definition of an "investment company" under the Investment Company Act of 1940. Hedge funds that want to avoid the requirements of the Investment Company Act would be exempt only if they file basic disclosure forms and cooperate with requests for information from the Securities and Exchange Commission.

"There wasn't much of an appetite for this sort of legislation before the financial crisis. I hope attitudes have changed and that Congress takes up this important legislation without delay," Grassley said. "A major cause of the current crisis is a lack of transparency. The wizards on Wall Street figured out a million clever ways to avoid the transparency sought by the securities regulations adopted during the 1930s. Instead of the free flow of reliable information that markets need to function properly, today we have confusion and uncertainty fueling an economic crisis." The bill introduced today is a version of legislation filed in two years ago by Grassley (S.1402) but never considered by Congress.

"Hedge funds control massive sums of money, and although they can cause serious damage to investors, other financial firms, and to the entire U.S. financial market, they are largely unregulated," said Levin. "If the events of the last year have taught us anything, it's that we need to regulate firms that are big enough to destabilize our economy if they fail. It's time to subject financial heavyweights like hedge funds to federal regulation and oversight to protect our investors, markets, and financial system."

Grassley said that Levin made an important addition to the transparency legislation in making clear that hedge funds have the same obligations under our money laundering statutes as other financial institutions. The bill introduced today would require hedge funds to establish anti-money laundering programs and report suspicious transactions.

The senators said their legislation is needed because of a 2006 decision by the D.C. Circuit Court of Appeals which overturned a regulation imposed by the Securities and Exchange Commission requiring hedge funds to register. The court said the Securities and Exchange Commission was going beyond its statutory authority and effectively ended all mandatory

registration of hedge funds with the Securities and Exchange Commission unless and until Congress takes action.

A summary of the legislation introduced today and floor statements by Grassley and Levin are below. The text of the bill is posted with this news release at http://finance.senate.gov and http://levin.senate.gov. The bill will be referred to the Senate Committee on Banking, Housing and Urban Affairs.

Hedge Fund Transparency Act of 2009

Background: This bill is a revised version of S. 1402, which Sen. Grassley introduced in the 110th Congress. While the previous bill amended the Investment Advisers Act of 1940, this bill amends the Investment Company Act of 1940 ("ICA"). However, the purpose is the same: to make it clear that the Securities and Exchange Commission has the authority to require hedge fund registration. This version also adds a provision authored by Sen. Levin to require hedge funds to establish anti-money laundering programs and report suspicious transactions.

Hedge Fund Registration Requirements

Definition of an Investment Company: Hedge Funds typically avoid regulatory requirements by claiming the exceptions to the definition of an investment company contained in §3(c)(1) or §3(c)(7) of the ICA. This bill would remove those exceptions to the definition, transforming them to exemptions by moving the provisions, without substantive change, to new sections §6(a)(6) and §6(a)(7) of the ICA.

Requirements for Exemptions: An investment company that satisfies either §6(a)(6) or §6(a)(7) will be exempted from the normal registration and filing requirements of the ICA. Instead, a company that meets the criteria in §6(a)(6) or §6(a)(7) but has assets under management of $50,000,000 or more, must meet several requirements in order to maintain its exemption. These requirements include:

1. Registering with the SEC.
2. Maintaining books and records that the SEC may require.
3. Cooperating with any request by the SEC for information or examination.
4. Filing an information form with the SEC electronically, at least once a year. This form must be made freely available to the public in an electronic, searchable format. The form must include:
    a. The name and current address of each individual who is a beneficial owner of the investment company.
    b. The name and current address of any company with an ownership interest in the investment company.
    c. An explanation of the structure of ownership interests in the investment company.
    d. Information on any affiliation with another financial institution.
    e. The name and current address of the investment company's primary accountant and primary broker.

f. A statement of any minimum investment commitment required of a limited partner, member, or investor.
g. The total number of any limited partners, members, or other investors.
h. The current value of the assets of the company and the assets under management by the company.

Timeframe and Rulemaking Authority: The SEC must issue forms and guidance to carry out this Act within 180 days after its enactment. The SEC also has the authority to make a rule to carry out this Act.

Anti-Money Laundering Obligations: An investment company exempt under §6(a)(6) or §6(a)(7) must establish an anti-money laundering program and report suspicious transactions under 31 U.S.C.A 5318(g) and (h). The Treasury Secretary must establish a rule within 180 days of the enactment of the Act setting forth minimum requirements for the anti-money laundering programs. The rule must require exempted investment companies to "use risk-based due diligence policies, procedures, and controls that are reasonably designed to ascertain the identity of and evaluate any foreign person that supplies funds or plans to supply funds to be invested with the advice or assistance of such investment company." The rule must also require exempted investment companies to comply with the same requirements as other financial institutions for producing records requested by a federal regulator under 31 U.S.C. 5318(k)(2).

Floor Statement of Senator Chuck Grassley of Iowa
Thursday, January 29, 2009

Mr. President, three years ago, I started conducting oversight of the SEC. That oversight began in response to a whistleblower that came to my office complaining that SEC supervisors were impeding an investigation into a major hedge fund. Soon afterward, I came to this floor to introduce an important piece of legislation based on what I learned from my oversight. The bill was aimed at closing a loophole in our securities laws that allows hedge funds to operate under a cloak of secrecy. Unfortunately, that bill, S. 1402, was never taken-up by the Banking Committee in the last Congress.

In light of the current instability in our financial system, I think it is critical for the Senate to deal with this issue in the near future. Therefore, I am pleased that Senator Levin and I worked together to produce an even better version of the bill for the 111th Congress, which we are introducing today.

This new bill, the Hedge Fund Transparency Act, does everything the previous version did and a bit more. Like the previous version, it clarifies current law to remove any doubt that the Securities and Exchange Commission (SEC) has the authority to require hedge funds to register, so the government knows who they are and what they're doing. It removes the loophole previously used by hedge funds to escape the definition of an "investment company" under the Investment Company Act of 1940.

Under this legislation, hedge funds that want to avoid the stringent requirements of the Investment Company Act will only be exempt if: one, they file basic disclosure forms and two, cooperate with requests for information from the Securities and Exchange Commission.

I want to thank Senator Levin for not only co-sponsoring this legislation, but also contributing a key addition to this new version of the bill. In addition to requiring basic disclosure, this version also makes it clear that hedge funds have the same obligations under our money laundering statutes as other financial institutions. They must report suspicious transactions and establish anti-money laundering programs.

One major cause of the current crisis is a lack of transparency. Markets need a free flow of reliable information to function properly. Transparency was the focus of our system of securities regulations adopted in the 1930's. Unfortunately, over time, the wizards on Wall Street figured out a million clever ways to avoid transparency. The result is the confusion and uncertainty fueling the crisis we see today.

This bill is an important step toward renewing the commitment to transparency on Wall Street. Unfortunately, there was not much of an appetite for this sort of common sense legislation when I first introduced it before the financial crisis erupted. Hopefully, attitudes have changed given all that has happened since the collapse of Bear Stearns last March.

Hedge funds are pooled investment companies that manage billions of dollars for groups of wealthy investors in total secrecy. Hedge funds affect regular investors. They affect the markets as a whole. My oversight of the SEC convinces me that the Commission needs much more information about the activities of hedge funds in order to protect the markets. Any group of organizations that can wield hundreds of billions of dollars in market power every day should be transparent and disclose basic information about their operations to the agency that Americans rely on as their watchdog for our nations' financial markets.

As I explained when I first introduced this bill, the SEC already attempted to oversee the hedge fund industry by regulation. Congress needs to act now because of a decision by a federal appeals court. In 2006, the D.C. Circuit Court of Appeals overturned an SEC administrative rule requiring the registration of hedge funds. That decision effectively ended all registration of hedge funds with the SEC, unless and until Congress takes action.

The Hedge Fund Transparency Act would respond to that court decision by: 1. including hedge funds in the definition of an investment company and 2. Bringing much needed transparency to this super secretive industry.

The Hedge Fund Transparency Act is a first step in ensuring that the SEC has clear authority to do what it already tried to do. Congress must act to ensure that our laws are kept up to date as new types of investments appear.

Unfortunately, this legislation hasn't had many friends. These funds don't want people to know what they do or who participates in them. They have fought hard to keep it that way. Well, I think that's all the more reason to shed some sunlight on them to see what they're up to.

I urge my colleagues to co-sponsor and support this legislation, as we work to protect all investors, large and small.

Mr. President, I yield the floor.

Floor Statement of Senator Carl Levin of Michigan (as prepared)
Thursday, January 29, 2009

Mr. President, history has proven time and again that markets are not self-policing. Today's financial crisis is due in part to the government's failure to regulate key market participants, including hedge funds that have become unregulated financial heavyweights in the U.S. economy. That's why I am joining today with my colleague Senator Grassley to introduce The Hedge Fund Transparency Act.

Hedge funds sound complicated, but they are simply private investment funds in which the investors have agreed to pool their money under the control of an investment manager. What distinguishes them from other investment funds is that hedge funds are typically open only to "qualified purchasers," an SEC term referring to institutional investors like pension funds and wealthy individuals with assets over a specified minimum amount. In addition, most hedge funds have one hundred or fewer beneficial owners. By limiting the number of their beneficial owners and accepting funds only from investors of means, hedge funds have been able to qualify for the statutory exclusions provided in Sections 80a-3(c)(1) and (7) of the Investment Company Act, and avoid the obligation to comply with that law's statutory and regulatory requirements. In short, hedge funds have been able to operate outside the reach of the SEC.

The primary argument for allowing these funds to operate outside SEC regulation and oversight is that, because their investors are generally more experienced than the general public, they need fewer government protections and their investment funds should be permitted to take greater risks than investment funds open to the investing public which needs greater SEC protection. Indeed, the ability of hedge funds to take on more risk is the reason that many individuals and institutions choose to invest in them. These investors accept more risk because that might lead to bigger rewards.

The compensation system employed by most hedge funds encourages that risk taking. Typically, investors agree to pay hedge fund investment managers a management fee of 2 percent of the fund's total assets, plus 20 percent of the fund's profits. The hedge fund managers profit enormously if the fund does well, but due to the guaranteed management fee, get a hefty payment even when the fund underperforms or fails. The analysis up to now has been that if wealthy people want to take big risks with their money, all else being equal, they should be allowed to do so without the safeguards normally required for the general public. So what's the problem with allowing their investment funds to operate outside federal regulation and oversight?

The problem is that hedge funds have gotten so big and are so entrenched in U.S. financial markets, that their actions can now significantly impact market prices, damage other market participants, and can even endanger the U.S. financial system and economy as a whole.

The systemic risks posed by hedge funds first became obvious ten years ago, in 1998. Back then, Long-Term Capital Management (LTCM) was a hedge fund that, at its peak, had more than $125 billion in assets under management and, due to massive borrowing, a total market position of roughly $1.3 trillion. When it began to falter, the Federal Reserve worried that it might unload its assets in a rush, drive down prices, and end up damaging not only other firms, but U.S. markets as a whole. To prevent a financial meltdown, the Federal Reserve worked with the private sector to engineer a rescue package.

That was just over a decade ago. Since then, according to a recent report issued by the Congressional Research Service, the hedge fund industry has expanded roughly tenfold. In 2006, the SEC testified that hedge funds represented 5 percent of all U.S. assets under management, and 30 percent of all equity trading volume in the United States. By 2007, an estimated 8,000 hedge funds were managing assets totaling roughly $1.5 trillion. The most current estimate is that 10,000 hedge funds are managing approximately $1.8 trillion in assets, after suffering losses over the last year of over $1 trillion.

In addition, over the last ten years, billions of dollars being managed by hedge funds have been provided by pension plans. A 2007 report by the U.S. Government Accountability Office (GAO) found that the amount of money that defined-benefit pension plans have invested in hedge funds has risen from about $3.2 billion in 2000, to more than $50 billion in 2006. That total is probably much higher now. And while most individual pension plans invest only a small slice of their money in hedge funds, a few go farther. For example, according to the GAO report, as of September 2006, the Missouri State Employees Retirement System had invested over 30 percent of its assets in hedge funds. Universities and charities have also directed significant assets to hedge funds. The result is that hedge fund losses threaten every economic sector in America, from the wealthy to the working class relying on pensions to our institutions of higher learning to our non-profit charities.

A third key development is that, over the last ten years, some of the largest U.S. banks and securities firms have set up their own hedge funds and used them to invest not only client funds, but also their own cash. In some cases, these hedge funds have commingled client and institutional funds and linked the fate of both to high-risk investment strategies. These hedge fund affiliates are typically owned by the same holding companies that own federally insured banks or federally regulated broker-dealers.

Because of their ownership, size and reach, their clientele, and the high-risk nature of their investments, the failure of a hedge fund today can imperil not only its direct investors, but also the financial institutions that own them, lent them money, or did business with them. From there, the effects can ripple through the markets and impact the entire economy.

Take, for example, the June 2007 collapse of two offshore hedge funds established by Bear Stearns. Those two hedge funds were not particularly large, but were heavily invested in

complex financial instruments tied to subprime mortgages. When the housing market weakened and mortgage-backed securities lost value, it wasn't just the hedge funds that suffered losses. It was also a number of large financial institutions which had lent them money or entered into business transactions with them, including its parent company, Bear Stearns.

As Bear Stearns began reporting losses and market confidence in the firm began dropping, the Federal Reserve and Treasury Department helped broker a deal allowing JPMorgan Chase to purchase the company. As part of that deal, the government agreed to take over $30 billion in troubled assets off the books of Bear Stearns, hiring an asset manager and putting taxpayers on the hook for them financially.

But the problems didn't stop there. Another financial institution, Merrill Lynch, had invested in the Bear Stearns hedge funds and also suffered losses. Those losses, when added to others, so damaged the company's bottom line that, despite a promise of $10 billion in new capital from the Troubled Asset Relief Program or TARP, Merrill Lynch was viewed by the market as teetering on the brink of collapse. With the government's encouragement, Bank of America stepped in and bought the company. As the extent of the Merrill Lynch losses became apparent, Bank of America itself began to lose market confidence. To counteract the Merrill Lynch losses, Bank of America wound up taking billions more taxpayer dollars under the TARP Program.

In the meantime, two managers of the Bear Stearns hedge funds were arrested on charges of conspiracy, securities fraud, and wire fraud. Their cases have yet to go to trial. But prosecutors allege that as the hedge funds were losing value, their managers were telling investors a very different story. "[B]elieve it or not," one of the financiers allegedly wrote in an e-mail to a colleague, "I've been able to convince people to add more money."

The two Bear Stearns hedge funds offer a sobering set of facts, but they represent only a small part of the story. Other hedge funds are contracting or folding as clients demand their money back. To meet client demands, hedge funds are selling lots of assets, further weakening stock and bond prices. As one leading hedge fund owner, George Soros, testified before Congress in November: "It has to be recognized that hedge funds were … an integral part of the bubble which now has burst."

Add on top of all that the Madoff scandal, and you've got to ask how anyone in their right mind could believe that the current regulatory exemption for hedge funds makes sense.

Four years ago, the Securities and Exchange Commission (SEC) tried on its own to beef up its regulation of hedge funds. In December 2004, the SEC issued a rule requiring hedge funds to register under the Investment Advisers Act, comply with the related regulations, and file a public disclosure form with basic information. The rule took effect on February 1, 2006, and by June 2006, over 2,500 hedge fund advisers had registered with the Commission. However, on June 23, 2006, the U.S. Court of Appeals for the District of Columbia Circuit vacated the SEC rule on the basis that it was not compatible with the Investment Advisers Act. Despite the SEC's asserting in the case reasons why hedge funds necessitated greater federal regulation and oversight, no further effort was made by either the SEC or the Congress to step into the breach.

As SEC Commissioner Luis Aguillar stated in a speech on January 9, 2009, the SEC "currently lacks tools in the hedge fund arena to provide effective oversight and supervision."

It is time for Congress to step into the breach and establish clear authority for federal regulation and oversight of hedge funds.

That is the backdrop for the introduction of the Grassley-Levin Hedge Fund Transparency Act. The purpose of this bill is to institute a reasonable and practical regulatory regime for hedge funds.

The bill contains four basic requirements to make hedge funds subject to SEC regulation and oversight. It requires them to register with the SEC, to file an annual disclosure form with basic information that will be made publicly available, to maintain books and records required by the SEC, and to cooperate with any SEC information request or examination.

The information to be made available to the public must include, at a minimum, the names of the companies and natural individuals who are the beneficial owners of the hedge fund and an explanation of the ownership structure; the names of any financial institutions with which the hedge fund is affiliated; the minimum investment commitment required from an investor; the total number of investors in the fund; the name of the fund's primary accountant and broker; and the current value of the fund's assets and assets under management. This information is similar to what was required in the disclosure form under the SEC's 2004 regulatory effort. The bill also authorizes the SEC to require additional information it deems appropriate.

In addition, the bill directs Treasury to issue a final rule requiring hedge funds to establish anti-money laundering programs and, in particular, to guard against allowing suspect offshore funds into the U.S. financial system. The Bush Administration issued a proposed anti-money laundering rule for hedge funds seven years ago, in 2002, but never finalized it. A 2006 investigation by the Permanent Subcommittee on Investigations, which I chair, showed how two hedge funds brought millions of dollars in suspect funds into the United States, without any U.S. controls or reporting obligations, and called on a bipartisan basis for the proposed hedge fund anti-money laundering regulations to be finalized, but no action was taken. Hedge funds are the last major U.S. financial players without anti-money laundering obligations, and it is time for this unacceptable regulatory gap to be eliminated.

Our bill imposes a set of basic disclosure obligations on hedge funds and makes it clear they are subject to full SEC oversight while, at the same time, exempting them from many of the obligations that the Investment Company Act imposes on other types of investment companies, such as mutual funds that are open for investment by all members of the public. The bill imposes a more limited set of obligations on hedge funds in recognition of the fact that hedge funds do not open their doors to all members of the public, but limit themselves to investors of means. The bill also, however, gives the SEC the authority it needs to impose additional regulatory obligations and exercise the level of oversight it sees fit over hedge funds to protect investors, other financial institutions, and the U.S. financial system as a whole.

The bill imposes these requirements on all entities that rely on Sections 80a-3(c)(1) or (7) to avoid compliance with the full set of the Investment Company Act requirements. A wide variety of entities invoke those sections to avoid those requirements and SEC oversight, and they refer to themselves by a wide variety of terms – hedge funds, private equity funds, venture capitalists, small investment banks, and so forth. Rather than attempt a futile exercise of trying to define the specific set of companies covered by the bill and thereby invite future claims by parties that they are outside the definitions and thus outside the SEC's authority, the bill applies to any investment company that has at least $50 million in assets or assets under its management and relies on Sections 80a-3(1) or (7) to avoid compliance with the full set of Investment Company Act requirements. Instead, those companies under the bill have to comply with a reduced set of obligations, which include filing an annual public disclosure form, maintaining books and records specified by the SEC, and cooperating with any SEC information request or examination.

Finally, our bill makes an important technical change. It moves paragraphs (c)(1) and (7) – the two paragraphs that hedge companies use to avoid complying with the full set of Investment Act Company requirements -- from Section 80a-3 to Section 80a-6 of the Investment Company Act. While our bill preserves both paragraphs and makes no substantive changes to them, it moves them from the part of the bill that defines "investment company" to the part of the bill that exempts certain investment companies from the Investment Company Act's full set of requirements.

The bill makes this technical change to make it clear that hedge funds really are investment companies, and they are not excluded from the coverage of the Investment Company Act. Instead, they are being given an exemption from many of that law's requirements, because they are investment companies which have voluntarily limited themselves to one hundred or fewer beneficial owners and to accepting funds only from investors of means. Under current law, the two paragraphs allow hedge funds to claim they are excluded from the Investment Company Act – they are not investment companies at all and are outside the SEC's reach. Under our bill, the hedge funds would qualify as investment companies – which they plainly are -- but would qualify for exemptions from many of the Act's requirements by meeting certain criteria.

It is time to bring hedge funds under the federal regulatory umbrella. With their massive investments, entanglements with U.S. banks, securities firms, pension funds, and other large investors, and their potential impact on market equilibrium, we cannot afford to allow these financial heavyweights to continue to operate free of government regulation and oversight.

When asked at a recent hearing of the Senate Homeland Security and Government Affairs Committee whether hedge funds should be regulated, two expert witnesses gave the exact same one-word answer: "Yes." One law professor, after noting that disclosure requirements don't apply to hedge funds, told the Committee: "[I]f you asked a regulator what … role did hedge funds play in the current financial crisis, I think they would look at you like a deer in the headlights, because we just don't know." It is essential that federal financial regulators know what hedge funds are doing and that they have the authority to prevent missteps and misconduct.

The “Hedge Fund Transparency Act” will protect investors, and it will help protect our financial system. I hope our colleagues will join us in support of this bill and its inclusion in the regulatory reform efforts that Congress will be undertaking later this year.